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No. 06-1509

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR PETITIONER

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TABLE OF CONTENTS

Page

INTRODUCTION 1

ARGUMENT 2

I. THE GOVERNMENT HAS ABANDONED THE FOUNDATION OF THE NINTH CIRCUIT RULE IT PURPORTS TO DEFEND 2

II. THE PHRASE "WITH RESPECT TO ITS STOCK" MERELY REQUIRES THAT A DISTRIBUTION BY A CORPORATION TO A SHAREHOLDER BE MADE WITHOUT CONSIDERATION OR EXPECTATION OF REPAYMENT 4

III. THE GOVERNMENT'S EMBEZZLEMENT THEORY DOES NOT WARRANT AFFIRMANCE 13

IV. SECTION 301 APPLIES TO UNLAWFUL DIVERSIONS 19

CONCLUSION 22

TABLE OF AUTHORITIES

Page

FEDERAL CASES

Artuz v. Bennett,
531 U.S. 4 (2000) 9

Barbourville Brick Co. v. Commissioner,
37 T.C. 7 (1961) 8

Boulware v. United States,
128 S. Ct. 32 (2007) 12

Brogan v. United States,
522 U.S. 398 (1998) 9

Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967),
aff'd sub nom. Commissioner v. Gordon,
391 U.S. 83 (1968). 4, 6

Crowley v. Commissioner,
962 F.2d 1077 (1st Cir. 1992) 7

Drybrough v. Commissioner,
238 F.2d 735 (6th Cir. 1956) 15, 19, 20

Dynamics Corp. of America v. United States,
392 F.2d 241 (Ct. Cl. 1968) 8

Elliotts, Inc. v. Commissioner,
716 F.2d 1241 (9th Cir. 1983) 7

Emmerson v. Commissioner,
44 T.C. 86 (1965) 8

Federbush v. Commissioner,
34 T.C. 740 (1960),
aff'd, 325 F.2d 1 (2d Cir. 1963) 8, 15, 16

Frankland Racing Equipment, Inc. v. Commissioner,
T.C. Memo 1987-210, 1987 Tax Ct. Memo LEXIS 206 ..... 14, 15, 20

Jama v. Immigration and Customs Enforcement,
543 U.S. 335 (2005) 6

Lengsfield v. Commissioner,
241 F.2d 508 (5th Cir. 1957) 8

M.J. Laputka and Sons, Inc. v. Commissioner,
T.C. Memo 1981-730, 1981 Tax Ct. Memo LEXIS 10 ..... 15, 16

Magnon v. Commissioner,
73 T.C. 980 (1980) 8

Neonatology Associates, P.A. v. Commissioner,
299 F.3d 221 (3d Cir. 2002) 4

Noble v. Commissioner,
368 F.2d 439 (9th Cir. 1966) 8

North Haven Board of Education v. Bell,
456 U.S. 512 (1982) 9

Paramount-Richards Theatres, Inc. v. Commissioner,
153 F.2d 602 (5th Cir. 1946) 8

Sachs v. Commissioner,
277 F.2d 879 (8th Cir. 1960) 8

Simon v. Commissioner,
248 F.2d 869 (8th Cir. 1957) 8

Stark v. Commissioner,
T.C. Memo 1999-1, 1999 Tax Ct. Memo LEXIS 2 ..... 14, 15

Truesdell v. Commissioner,
89 T.C. 1280 (1987) 3, 7, 19

United States v. D'Agostino,
145 F.3d 69 (2d Cir. 1998) 11, 19, 21

United States v. Miller,
545 F.2d 1204 (9th Cir. 1976) 2, 3, 5, 10, 12

STATE CASES

In re Cysive, Inc. Shareholders Litigation, 836 A.2d 531 (Del. Ch. 2003) 14

STATUTES AND REGULATIONS

26 U.S.C. § 165 14

26 U.S.C. § 301 ..... *passim*

26 U.S.C. § 316 ..... 1, 9, 13, 21

26 C.F.R. § 1.301-1(c) 5

MISCELLANEOUS

1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed. 2006) 4

REPLY BRIEF FOR PETITIONER

INTRODUCTION

The government concedes that the taxation rules in IRC § 301 apply in civil cases just as in criminal cases. It thus abandons the Ninth Circuit's rationale for the contemporaneous intent requirement. *See* Part I *infra*.

Having disavowed the court of appeals' justification for its intent requirement, the government constructs a *new* requirement--one that Boulware has not had an opportunity to satisfy--from statutory language ("with respect to its stock") that never mentions intent and that no court has ever interpreted to create such a standard. The Court should reject the government's intent requirement and adopt instead the Second Circuit's application of the return of capital rule, which follows the plain language of IRC §§ 301 and 316. *See* Part II *infra*.

The government contends that Boulware cannot invoke the return of capital rule because he "embezzled" the diverted money from HIE. This argument has three flaws. First, IRC §§ 301 and 316 contain no exception for funds that a shareholder embezzles. Second, as the IRS has successfully argued in other cases, a controlling shareholder of a close corporation cannot embezzle from his own company. Finally, if the Court concludes that embezzled funds cannot be a return of capital, then

Boulware must be afforded a jury determination on the embezzlement issue. *See* Part III *infra*.

As a fallback argument, the government asserts that the return of capital rule does not apply because Boulware's diversion of HIE funds was unlawful in other respects. But the statutory language contains no such exception, and the government offers no persuasive reason for the Court to create one. Even if the Court determines that such an exception could apply under some circumstances, Boulware must be permitted to contest the unlawfulness issue before a jury. *See* Part IV *infra*.

ARGUMENT

I. THE GOVERNMENT HAS ABANDONED THE FOUNDATION OF THE NINTH CIRCUIT RULE IT PURPORTS TO DEFEND.

The Ninth Circuit rests the contemporaneous intent requirement on a purported distinction between civil and criminal tax cases. *Miller*, which created the intent requirement, declared that applying the civil return of capital rule in a criminal tax case would "completely ignore[] one essential element of the crime charged: the willful intent to evade taxes, and concentrate[] solely on the issue of the nature of the funds diverted," which "is not the important element." *United States v. Miller*, 545 F.2d 1204, 1214 (9th Cir. 1976). Citing *Miller*, the court below emphasized that "the characterization of diverted corporate funds for civil tax purposes does

not dictate their characterization for purposes of a criminal tax evasion charge." Pet. App. 5. And the court rejected Boulware's reliance on *Truesdell v. Commissioner*, 89 T.C. 1280 (1987), because "*Truesdell* was a civil proceeding and thus inapposite given *Miller's* explicit holding that civil classifications of diverted corporate funds do not control in criminal cases." Pet. App. 5.

Boulware demonstrated in his opening brief that the Ninth Circuit approach improperly disregards the tax deficiency element of tax evasion and creates an unwarranted disparity between tax rules in civil and criminal cases. *See* Brief for Petitioner 15-26 ("Pet. Br."). The government now acknowledges--directly contrary to the Ninth Circuit's position in this case and in *Miller*--that the return of capital rule applies in criminal tax cases exactly as it does in civil tax cases. Brief for the United States 12, 19 n.4, 24 ("Gov't Br.").

Having correctly abandoned the Ninth Circuit's rationale for the contemporaneous intent requirement, the government develops a new theory, based on the phrase "with respect to its stock" in IRC § 301(a).[1] As discussed in the next part, however, that phrase has a settled meaning that does not turn upon the intent of the corporation or the shareholder. Neither the statutory text nor the

[1] The government, which rests its case in this Court on that single phrase, never relied on it in the district court or before the court of appeals panel. It began developing the argument it advances now in its opposition to Boulware's petition for rehearing en banc. Neither in *Miller* nor in this case did the court of appeals place any weight on the phrase the government now finds decisive.

cases construing that language support the government's position.

II. THE PHRASE "WITH RESPECT TO ITS STOCK" MERELY REQUIRES THAT A DISTRIBUTION BY A CORPORATION TO A SHAREHOLDER BE MADE WITHOUT CONSIDERATION OR EXPECTATION OF REPAYMENT.

A. As Boulware noted in his opening brief (Pet. Br. 27-28), courts consider a distribution to a shareholder to be "with respect to [the corporation's] stock" if the corporation confers a benefit on the shareholder without expectation of repayment and without receiving equal value.[2] "[T]he phrase 'distributes . . . with respect to . . . stock' is a term of art with a consistent meaning throughout the Code. It is used only to refer to distributions without consideration, not to sales for a cash consideration." *Commissioner v. Baan*, 382 F.2d 485, 493 (9th Cir. 1967), *aff'd on other grounds sub nom. Commissioner v. Gordon*, 391 U.S. 83 (1968). This settled interpretation of "with respect to its stock" does not rest upon the intent of the corporation or the shareholder.

The government ignores the cases construing the "with respect to its stock" language. It purports to find in that phrase something that no court has ever found there: a requirement that the share-

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[2] *See, e.g., Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221, 231-32 (3d Cir. 2002); 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 8.05[1], at 8-39 (7th ed. 2006).

holder or the corporation *intend* that the distribution be with respect to the corporation's stock or *intend* that it be to the shareholder in his capacity as such. Gov't Br. 11, 18, 23-24, 33.

The text of IRC § 301 does not support the government's proposed interpretation. The statute does not mention intent. The government acknowledges that the "plain meaning" of the "with respect to its stock" phrase "limits the applicability of Section 301's tax treatment to distributions that are made to shareholders *qua* shareholders, *i.e., by reason of* the recipients' status as shareholders"--a formulation that does not involve intent. Gov't Br. 15. Turning to dictionaries, the government finds "with respect to" defined as "with reference to," "as regards," "insofar as concerns," "referring to," "concerning," "regarding," and "as to." *Id.* at 16 & n.3. None of these definitions involves intent. Nor does the IRS interpretive regulation, 26 C.F.R. § 1.301-1(c), or the legislative history of IRC § 301. *See* Gov't Br. 16.

Summarizing the definitions on which it relies, the government concludes: "Applying those ordinary meanings [of 'with respect to'] here, the plain text of Section 301(a) requires that the distribution of property by the corporation be made to a shareholder because of his ownership of its stock." Gov't Br. 16; *see id.* at 21 (requiring evidence of a "causal link" between the distribution and stock ownership). But a *causal* relation does not necessarily require intent. A rock rolls down a hill *because of* gravity, but that causal relation does not

require intent. A person slips *because* the sidewalk is icy, but that causal relation does not require intent. And a controlling shareholder such as Boulware receives corporate distributions *because* he owns stock, but that causal relation does not require that the shareholder or the corporation have any particular intent with respect to the distribution.

The "causal link" that the government finds in the statutory phrase "with respect to its stock" squares easily with the interpretation courts have uniformly given that phrase--a "distribution[] without consideration." *Baan*, 382 F.2d at 493. When a corporation distributes funds to a shareholder without consideration--without, for example, receiving services in return--it does so *because of* the shareholder's status as shareholder. But that "causal link" does not require that either the corporation or the shareholder have any particular intent. Because the contemporaneous intent requirement has no basis in the "with respect to its stock" phrase or any other part of the statutory text, the Court should reject it. *See, e.g., Jama v. Immigration and Customs Enforcement*, 543 U.S. 335, 341 (2005) ("We do not lightly assume that Congress has omitted from its adopted text requirements that it nonetheless intends to apply . . . .").

B. The government insists that "the approach of the court below is consistent with civil tax cases." Gov't Br. 24-31. But the government does not cite a single civil tax case interpreting the "with respect to its stock" phrase to require contemporaneous intent by the shareholder or the corpor-

ation. Most important, the Tax Court in *Truesdell*--which settled the application of the return of capital rule in civil cases--did not read that phrase to create such a requirement.

The government cites cases holding that intent may be relevant when a shareholder or the IRS contends that the shareholder received corporate funds as an employee or a creditor. It argues that "[p]etitioner offers no explanation why intent should be relevant to determining whether a payment was made by reason of a nonshareholder capacity, but not by reason of a shareholder capacity" and characterizes the two circumstances as "opposite sides of the same coin." *Id.* at 19.

Intent plays a different role in these circumstances for obvious reasons. The nonshareholder relationships that IRC § 301(a) excludes from the taxation rules in § 301(c)--employer/employee and lender/borrower, for example--generally depend for their formation on the intent of the parties. *See, e.g., Crowley v. Commisioner*, 962 F.2d 1077, 1079 (1st Cir. 1992) (loan); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1244-48 (9th Cir. 1983) (employee). Thus, courts routinely look to the parties' intent to determine if one of these relationships exists.

By contrast, the shareholder relationship arises automatically from the purchase of shares, without any particular intent by the stock purchaser or the corporation. When the shareholder controls the corporation, as Boulware did HIE, money he obtains from it without providing equivalent value in return is a "distribution . . . with respect to [the

corporation's] stock," even though "neither the corporation nor the shareholder intended a dividend." *Mignon v. Commissioner*, 73 T.C. 980, 993-94 (1980). This--and not the government's novel position--is the "ordinary rule in civil tax cases." Gov't Br. 28; *see, e.g., Dynamics Corp. of America v. United States*, 392 F.2d 241, 247 (Ct. Cl. 1968); *Noble v. Commissioner*, 368 F.2d 439, 443 (9th Cir. 1966); *Lengsfield v. Commissioner*, 241 F.2d 508, 511 (5th Cir. 1957); *Emmerson v. Commissioner*, 44 T.C. 86, 90-91 (1965); *Barbourville Brick Co. v. Commissioner*, 37 T.C. 7, 13 (1961).[3]

C. The government argues that the Court should graft a contemporaneous intent requirement onto the return of capital rule to avoid encouraging tax fraud. Gov't Br. 12, 22-24. The statutory language suffices to dispose of this policy argument. Even if the government were correct about the effect of the Second Circuit's position, the Court could not add an intent requirement to the plain language of

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[3] The government suggests that the absence of distributions to HIE's other shareholder precludes treating the distributions as "with respect to its stock" and thus subject to IRC § 301(c). Gov't Br. 35 n.12. But the government cites no authority for this proposition, and the law is to the contrary. In *Federbush v. Commissioner*, 34 T.C. 740 (1960), *aff'd*, 325 F.2d 1 (2d Cir. 1963) (per curiam), for example, the Tax Court declared that "[a] distribution of corporate earnings may constitute a dividend even though the formalities of a dividend declaration are not observed, even though the distribution is not recorded on the corporate books as such, even though it is not in proportion to the stockholdings, and even though some of the stockholders do not participate in its benefits." 34 T.C. at 750; *see, e.g., Sachs v. Commissioner*, 277 F.2d 879, 882 (8th Cir. 1960); *Simon v. Commissioner*, 248 F.2d 869, 875 (8th Cir. 1957); *Paramount-Richards Theatres, Inc. v. Commissioner*, 153 F.2d 602, 604 (5th Cir. 1946).

IRC §§ 301 and 316. *See, e.g., Artuz v. Bennett*, 531 U.S. 4, 10 (2000) ("Whatever merits these and other policy arguments may have, it is not the province of this Court to rewrite the statute to accommodate them."); *Brogan v. United States*, 522 U.S. 398, 408 (1998) ("Courts may not create their own limitations on legislation, no matter how alluring the policy arguments for doing so . . . ."); *North Haven Board of Education v. Bell*, 456 U.S. 512, 535 n. 26 (1982) ("These policy considerations were for Congress to weigh, and we are not free to ignore the language and history of [the statute] even were we to disagree with the legislative choice.").

But the premise of the government's argument is wrong in any event, for two key reasons. First, a return of capital subject to IRC § 301(c)(2) provides no taxable gain to the shareholder. The shareholder merely receives back the money that he invested in the corporation, diminishing the value of his shares in the process. The return of the shareholder's investment, with the accompanying diminution in value of his shares, produces no income to the shareholder.

Second, under the plain terms of IRC § 301(c), the shareholder can never claim a return of capital that exceeds his total basis in the stock. A shareholder with a five dollar basis can never claim more than a five dollar return of capital (and then only if the corporation lacks earnings and profits). That is because each return of capital is "applied against and reduce[s] the adjusted basis of the stock." IRC § 301(c)(2). Thus, there is no possibility that a

shareholder can obtain (for example) ten dollars of nontaxable return of capital on five dollars of basis.

These points refute the government's "invitation to tax fraud" argument. It is *always* the case, with or without the return of capital rule, that a taxpayer who conceals money does not have to pay taxes on it unless he gets caught. But the return of capital rule does not *increase* a taxpayer's incentive to conceal money. Whether or not a shareholder conceals diverted funds from the IRS, and whether or not the IRS discovers those concealed funds, the shareholder can never claim more than the amount of his basis--the amount he has put into the corporation--as a return of capital.

The government offers a second policy argument. Echoing *Miller*, it declares that applying the return of capital rule as written "would create an anomaly." Gov't Br. 23. According to *Miller*, "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in the stock) for failure to report such sums as income; while that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." 545 F.2d at 1214 (quoted at Gov't Br. 23). The government implies that the contemporaneous intent requirement is necessary to cure this "anomaly."

But this is not an anomaly; it is the difference between a defendant who violates the tax evasion statute and one who does not. The government

cannot prove the "tax deficiency" element of tax evasion against the defendant whose corporation has no earnings and profits. It *can* prove that element against the defendant whose corporation *does* have earnings and profits and who thus cannot present a return of capital defense. The first defendant is guilty; the second is not. Simply put, "The diversion of the funds cannot constitute a criminal offense, despite criminal intent, if no taxes are due." *United States v. D'Agostino*, 145 F.3d 69, 73 (2d Cir. 1998); *see* Pet. Br. 20-21.

D. The government's proposed intent standard not only lacks any textual basis, case support, or coherent policy rationale; it also differs markedly from the standard that the district court and the court of appeals insisted Boulware meet. The district court declared that "if the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions were intended to be *a return of capital*." JA 91 (emphasis added). Affirming, the court of appeals likewise held, in accordance with *Miller*, that in criminal tax cases the defendant must show that the corporate distribution was "intended to be *a return of capital*." Pet. App. 4 (emphasis added). The question on which this Court granted certiorari, drawn verbatim from the government's opposition, is whether the return of capital rule automatically applies to a shareholder's diversion of corporate funds (assuming the earnings and profits and basis predicates are met), "even if the diversion was not intended as a *return of capital*." *Boulware v. United States*, 128 S. Ct. 32 (2007) (emphasis added).

An intent that a diversion be a "return of capital" is different than an intent that a diversion be a "distribution with respect to [the corporation's] stock" (Gov't Br. 33) or a "distribution to the shareholder in his capacity as such" (Gov't Br. 18). Boulware has acknowledged that he cannot establish a contemporaneous intent to treat the money he received from HIE as a "return of capital." By contrast, Boulware has never had an opportunity to show his understanding that he obtained the diverted funds because of his ownership of HIE's stock and in his capacity as an HIE shareholder (and not, for example, as compensation for his services as HIE's president). If the Court adopts the government's proposed standard, Boulware should receive a new trial at which he can produce evidence satisfying the new requirement.

The government appears uncertain whether a showing of contemporaneous intent is *required* for a defendant to invoke the return of capital rule.[4] At several points, the government casts intent merely as one of many "facts and circumstances" that a factfinder considers in resolving the "with respect to its stock" issue. The government contends, for example, that "[w]hether a corporate payment meets [the 'with respect to its stock'] requirement turns on

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[4] The government equivocates as well on whether the taxpayer, the corporation, or both must possess the requisite intent (however defined). *See* Gov't Br. 12 (referring to "the intent of the corporation and the parties"); *id.* (referring to "the purported intent of the corporation or shareholder"); *id.* at 18 ("'taxpayer and/or the corporation'" (quoting *Miller*, 545 F.2d at 1215)), 24 ("intent of the corporation and the shareholder"), 29 ("intent of the corporations and employees"), 30 ("intent of the corporation and the taxpayer").

all the facts and circumstances of the case." Gov't Br. 11. Those "facts and circumstances" include, according to the government, "the intent of the corporation and the parties." *Id.* at 12; *see id.* at 24, 30.

If the government's "facts and circumstances" formulation is correct, then the district court and the court of appeals erred in holding that the intent showing is a threshold requirement the defendant *must* satisfy to invoke the return of capital rule, rather than merely a "fact or circumstance" to be considered along with many others. Here too, if the Court adopts the government's standard, Boulware should receive a new trial at which he has an opportunity to satisfy it.

III. THE GOVERNMENT'S EMBEZZLEMENT THEORY DOES NOT WARRANT AFFIRMANCE.

The government insists that Boulware embezzled the funds he obtained from HIE and that embezzled funds cannot be a return of capital. *E.g.*, Gov't Br. 18, 21, 36-37. This argument fails for three reasons.

First, nothing in the text of IRC §§ 301 and 316 supports a general exclusion of embezzled or stolen funds from the taxation rules of § 301(c). Some shareholder thefts will undoubtedly occur under circumstances that do not fall within the statutory terms. Boulware offered an example in his opening brief (Pet. Br. 33): if a burglar who happens to own a few General Motors shares breaks into the

company's headquarters and steals the petty cash, that will not be a "distribution" by the corporation to the shareholder "with respect to its stock." But when a controlling shareholder such as Boulware diverts funds from a close corporation, the taxation rules in IRC § 301(c) apply according to their plain language, regardless of whether the transaction could be characterized under state law as an offense against the corporation.[5]

Second, in a series of cases the IRS has successfully--and correctly--argued that the controlling shareholder of a close corporation cannot embezzle from his own corporation. *See, e.g., Stark v. Commissioner*, T.C. Memo 1999-1, 1999 Tax Ct. Memo LEXIS 2, at *12-*13; *Frankland Racing Equipment, Inc. v. Commissioner*, T.C. Memo 1987-210, 1987 Tax Ct. Memo LEXIS 206, at *69; *M.J. Laputka and Sons, Inc. v. Commissioner*, T.C. Memo 1981-730, 1981 Tax Ct. Memo LEXIS 10, at *30; *Federbush v. Commissioner*, 34 T.C. 740, 750-51 (1960), *aff'd*, 325 F.2d 1 (2d Cir. 1963) (per curiam).

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[5] Boulware indisputably controlled HIE. *See, e.g., In re Cysive, Inc. Shareholders Litigation*, 836 A.2d 531, 552-53 (Del. Ch. 2003). He founded the company, owned fifty percent of the stock, and served as chairman and president. The other fifty percent of the stock was held by a trust that Boulware created for his son, with the boy's mother (Boulware's girlfriend, Jin Sook Lee) as trustee. JA 68, 74, 82-83, 86-88, 133. In closing argument the government acknowledged that HIE was Boulware's corporation; it declared: "And that's what this case is all about: The money this defendant stole, or embezzled if you like that word better, from his own corporation." ER 815; *see, e.g.*, ER 817 ("his corporation"), 818 (arguing that Boulware "took millions of dollars from his company and put it in his pocket and spent it, in large part, on his first wife and his girlfriend, with no tax consequences to him"), 819 ("his company"), 820 ("his corporation").

In each of these cases, the corporate taxpayer claimed a deduction for a theft loss under IRC § 165 based on a controlling shareholder's diversion of funds from the corporation. The IRS argued successfully that a controlling shareholder necessarily lacks the intent to embezzle from his own corporation.

In *Stark*, for example, the Tax Court found it "well established that a diversion of corporate funds by shareholders with complete, or near complete, control of the corporation does not entitle the corporation to a theft loss deduction, regardless of how embezzlement is defined under local law. . . . In such a situation, the shareholders have the implied consent of the corporation and take the funds under a claim of right." 1999 Tax Ct. Memo LEXIS 2, at *12-*13; *see, e.g., Drybrough v. Commissioner*, 238 F.2d 735, 738 (6th Cir. 1956) (same).

In *Frankland Racing Equipment*, the IRS argued that "no embezzlement occurred where a dominate [sic] shareholder misappropriates corporate monies as the requisite intent to embezzle is absent." 1987 Tax Ct. Memo LEXIS 206, at *69. The Tax Court agreed. It found that Frankland (the controlling shareholder) "had no intent to embezzle from Frankland Racing as his objective was to conceal the financial performance of the corporation from [his wife] and to evade tax. The funds diverted pursuant to the scheme are accurately classified as constructive dividends." *Id.*; *see Federbush*, 325 F.2d at 2 (no embezzlement by controlling shareholders

where "[t]he sole controlling purpose of the diversion was evasion of income taxes").

In *M.J. Laputka and Sons*, the Tax Court agreed with the IRS' argument that "inasmuch as the shareholders who misappropriated the money also dominated the corporation, it would be anomalous to say that there was the requisite intent to embezzle. They would be taking money from themselves, and this does not constitute embezzlement." 1981 Tax Ct. Memo LEXIS 10, at *30. The court concluded: "The money diverted by [the controlling shareholders] and used by them for their personal benefit is more accurately described as disguised dividends to them." *Id.* at *31.

These cases and others like them confirm, in keeping with the longstanding position of the IRS, that corporate diversions by controlling shareholders cannot be considered embezzlement and must instead be taxed in accordance with IRC § 301(c).

Third, if the Court concludes that funds a controlling shareholder embezzles from his own corporation do not fall within IRC § 301(c), then Boulware should receive a jury determination on the elements of embezzlement. The government concedes that the jury was not "expressly instructed" on embezzlement or any other theory of unlawfulness. Gov't Br. 37. But the government cites a portion of the closing argument in which the prosecutor claimed that Boulware embezzled or stole the diverted funds from HIE and insists that the jury "necessarily . . . accepted the government's theory of the case." *Id.* (citing ER 815-20).

The government is wrong. Nothing in the district court's instructions required the jury to make any finding that Boulware had embezzled from HIE. *See* ER 845-63 (jury instructions). The jury could have found Boulware guilty of tax evasion and tax perjury without coming to any conclusion about whether he had otherwise acted unlawfully.

The government argued the opposite of its current position in Boulware's first appeal. On that appeal, Boulware contended that the evidence was insufficient because the government had failed to prove that he embezzled or stole the diverted funds from HIE. He argued as well that the government's embezzlement claim had constructively amended the indictment, which did not allege that offense. Appellant Boulware's Corrected Opening Brief at 20-35, Nos. 02-10287, 02-10338 (9th Cir.) (available on Westlaw at 2003 WL 22706800).

The government countered these arguments in terms that refute its position here. It declared that "[n]either in the indictment nor during its presentation of evidence did the government attempt to place any label on the funds diverted by defendant, other than 'income.' . . . Depending on the circumstances, the diverted funds could have constituted, *inter alia*, embezzled or stolen funds, dividends, commissions, or some form of bonus or salary." Brief for the Appellee/Cross-Appellant at 16, Nos. 02-10287, 02-10338 (9th Cir.) (available on Westlaw at 2003 WL 22706655). The government observed that the district court had instructed the jury that attorneys' arguments are not evidence. *Id.*

at 17. It noted that the court's instructions "did not include, as an essential element, that defendant obtained the funds by theft from HIE." *Id.* It concluded that "[n]either the charges in the indictment nor the government's theory of the case depended on the violation of Hawaii state law concerning theft, and accordingly the indictment did not need to allege, nor did the government have to prove, a violation of state law." *Id.* at 18-19; *see id.* at 21 ("The language of the indictment did not require the government to prove that defendant stole money from HIE in violation of Hawaii law. . . . Thus, proof of the tax charges did not require the Government to establish that defendant obtained the unreported income through theft.").

The Ninth Circuit accepted the government's argument. It agreed that the government "could have proved the elements of §§ 7206(1) and 7201 beyond a reasonable doubt without proving . . . that Boulware stole the funds from HIE . . . ." Pet. App. 54.

The government's arguments to the court of appeals on Boulware's first appeal apply equally here. In Boulware's second trial, as in his first, the government argued in closing that Boulware embezzled or stole the diverted funds from HIE. ER 815-20. In Boulware's second trial, as in his first, the indictment did not allege theft or embezzlement, and the instructions did not require the jury to find those offenses in convicting Boulware. ER 23-34 (indictment), 845-63 (instructions). In Boulware's second trial, as in his first, the district court

instructed the jury that the attorneys' arguments are not evidence. ER 855. It is wrong, therefore, to contend, as the government does, that the jury necessarily found that Boulware embezzled the diverted funds from HIE. Because there has been no such finding, the Sixth Amendment precludes application on appeal of an embezzlement exception to the return of capital rule.

IV. SECTION 301 APPLIES TO UNLAWFUL DIVERSIONS.

The government argues in the alternative that the taxation principles in IRC § 301(c) do not apply to "unlawful" shareholder diversions of corporate assets. Apart from Boulware's alleged embezzlement from HIE--discussed above--the government asserts that Boulware acted unlawfully toward the other HIE shareholder (a trust that he established in favor of his young son, with the boy's mother, Jin Sook Lee, as trustee) and that he diverted corporate funds to Jin Sook Lee to defraud his wife. Gov't Br. 35-36.

The government has no textual basis for such an exception to the return of capital rule. It cites no case that has applied such an exception to defeat a return of capital claim; the language it quotes from *D'Agostino*, *Truesdell*, and other cases is dictum. The government has not found a word of legislative history to support the exception. And it offers no policy justification for permitting the tax treatment of a corporate distribution to a shareholder to turn on whether the transaction amounts to an actionable wrong against a third party. Such an exception to

IRC § 301(c) would introduce a substantial element of uncertainty into the tax system with no corresponding benefit.

The government purports to distinguish *Drybrough* on the basis that the court "rejected the claim that the defendants had embezzled the funds." Gov't Br. 36 n.13. That is true, but it misses the point in this context.[6] *Drybrough* is important here because in that case the holders of 80 percent of the stock of a close corporation diverted corporate funds to themselves. The wife of one of the shareholders--who held 20 percent of the stock--did not know about the diverted funds. *See* 238 F.2d at 738. In holding that the predecessor provisions to IRC §§ 301 and 316 controlled the taxation of the diverted funds, the court of appeals never suggested that the controlling shareholders' possible breach of their fiduciary duty to the minority shareholder removed the distributions from the taxation rules that now appear in IRC § 301(c). *See id.*; *see also Frankland Racing Equipment*, 1987 Tax Ct. Memo LEXIS 206, at *7, *18-*19, *24, *52, *69 (controlling shareholder's diversion of corporate assets taxed as constructive dividends where intent was in part to "conceal the financial performance of the Corporation from [his wife]," who was a minority shareholder and from whom he was getting a divorce).

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[6] The portion of *Drybrough* on which the government relies squarely supports Boulware's argument in Part III that as a controlling shareholder he could not embezzle from HIE. The *Drybrough* court declared, in terms directly applicable here, that the controlling shareholders "took the corporation's funds under a claim of right and with the implied consent of the corporation" and thus did not embezzle. 238 F.2d at 738.

Even if the Court were to adopt the government's proposed exception to the plain language of IRC §§ 301 and 316, that would not change the outcome here. The government tacitly concedes that in the district court it "did not allege or prove that [Boulware's] diversions of corporate funds were unlawful" in either of the respects it now identifies. *D'Agostino*, 145 F.3d at 73. Nor did the government contest the lawfulness of the HIE diversions to Boulware before the Ninth Circuit panel. Judge Thomas raised that issue for the first time in his concurrence. Pet. App. 14. If an element of the offenses with which Boulware is charged turns on whether the HIE distributions defrauded his son's trust or his former wife, the Sixth Amendment guarantees him the opportunity to contest that issue before the jury.[7]

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[7] Although the matter must be decided by a jury if the Court finds it relevant, we note that the state court pleadings to which the government cites do not support its claim that Boulware diverted funds to Jin Sook Lee "for the purpose of preventing his wife from obtaining the portion of the corporation's assets to which she was entitled in their divorce." Gov't Br. 35. To the contrary, Boulware contended in the state court action--and the state court judge and jury agreed--that he transferred the funds to Jin Sook Lee to hold on behalf of HIE so that the corporation could buy out Boulware's wife's interest. *See, e.g.*, Pet. App. 31-36; JA 73-80, 83-85. The record reflects that the money was transferred to Lee not to defraud Boulware's wife, but to ensure that HIE could pay her for her interest in the company.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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